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Person To Contact:

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Date:

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LEGEND

Taxpayer =

Corp =

Agency =

UNR =

V =

W =

X =

Y =

Z =

Year 1 =

Year 2 =

Year 3 =

Date 1 =

Date 2 =

Date 3 =

Date 4 =

a =

b =

c =

d =

e =

f =

g =

h =

Dear _____ :

This responds to your request for a private letter ruling, dated May 27, 2015, regarding the application of §1033 of the Internal Revenue Code to your transaction. Specifically, you request a ruling that there was a condemnation or requisition of property under § 1033 and that the proposed replacement property, whether acquired by purchase or construction, is similar or related in service or use to the property converted.

FACTS

History of Legal Relationship between Taxpayer and Agency

Taxpayer is the parent of an affiliated group that files a consolidated federal income tax return on the basis of a calendar taxable year. One member of the affiliated group is Corp, a wholly-owned subsidiary of Taxpayer. Corp, either directly or through wholly-owned LLCs that are disregarded entities for federal income tax purposes, operates facilities at X pursuant to contracts with Agency. Corp and its predecessors have been Y at Z since Year 1. Corp has not only operated facilities at Z, it has also, at its own expense, built or bought many buildings and other improvements at Z.

The nature of Corp's property interest in the buildings and other improvements it constructed or purchased at Z is unique.¹ Beginning in Year 1, Agency has contracted with private parties to operate and develop public accommodation facilities at X. Agency never has had the funds available to build the public accommodation facilities needed in X. Therefore, it has adopted policies designed to encourage private parties to make the substantial investments required to build such facilities. These policies could not provide private parties with legal title to the facilities because, by law, Agency holds and retains title to all facilities built on Agency land.

As Agency could not provide legal title to Corp, Agency provided standard provisions in its contracts that recognized Corp's rights in the facilities constructed or purchased including the right to receive just compensation for the facilities if Agency took the facilities or granted a third party the privilege to operate those facilities. Effectively, the contracts placed Corp in the same position as one holding formal title to the facilities when condemned by a government entity.

In Year 2, after concerns were expressed about the contractual rights of the parties, Congress passed legislation codifying the existing Agency policy and providing Corp with a statutory property right in the facilities built on Agency land. Essentially, the statutory right is a beneficial ownership interest (BOI) that could not be taken for public

¹ To our knowledge, this type of property interest is not used by any other state or federal agency or by private industry.

use without just compensation. However, the BOI does not include any interest in the land on which the related capital improvements are situated.

In Year 3, additional Congressional hearings were held concerning Agency policy that culminated in the passage of very similar legislation. The legislation, which is currently in effect, preserved the long-standing policy of Agency that was codified in Year 2 that gave Corp a BOI in the facilities built on Agency land. It granted the right to just compensation if the improvements are taken by Agency or if Agency bestows the privilege to operate these improvements (facilities) to a third party. Additional statutory provisions provide that a current BOI: (i) shall not be extinguished by the expiration or termination of the underlying contract, and (ii) may be pledged as security for financing of a capital improvement or the acquisition of a contract with Agency.

The beneficial ownership rights of Corp are created by statute and exist outside of the contract with Agency. In this regard, for both financial reporting and tax purposes, Corp has consistently treated itself as the owner of the improvements at Z and has depreciated those improvements over their appropriate federal tax lives.

The Transaction

On Date 1, prior to the expiration of its current contract with Corp, Agency “bought down”² approximately a percent of Corp’s BOI in Z, paying Corp \$ b. On Date 2, pursuant to the award of a new contract by Agency to an unrelated third party, UNR, Corp received a payment of approximately \$ d from UNR for approximately c percent of Corp’s BOI in Z. The amounts paid to Corp were determined pursuant to methodology established by the underlying statute.

Taxpayer represents that Corp vigorously resisted the buy down and the award of a new contract to UNR, and had no choice but to accept the implementation of the statutory provisions.

On Date 3, Agency awarded a new contract to Corp to operate as Y at V. Corp has commenced several construction projects at V that are expected to increase Corp’s statutory BOI at V to approximately \$ e. Additionally, on Date 4, Agency awarded a new contract to Corp to operate as Y at W, which required Corp to purchase existing buildings and improvements at W that are expected to increase Corp’s BOI at W to approximately \$ f.

The old BOI at Z and the new BOI at V and W relate to buildings that were or are used by Corp in its business of operating as Y for X. The vast majority of these buildings are accommodations, retail shops, administrative buildings, and other support buildings, all of which are essential to the business of operating as Y for X. In its submissions for this

² A “buy down” is a term coined by Agency. In a buy down, Agency forcibly purchases or takes a portion of the private parties BOI.

ruling, Taxpayer attached several exhibits showing the composition of the replacement BOI at W and a projected list of the buildings and values that are expected to compose the replacement BOI at V.

LAW AND ANALYSIS

Section 1033(a)(2) of the Code provides, in part, that if property (as a result of its destruction in whole or in part, theft, seizure, or requisition or condemnation or threat or imminence thereof) is compulsorily or involuntarily converted into money and if the taxpayer during the period specified in § 1033(a)(2)(B), for the purpose of replacing the property so converted, purchases other property similar or related in service or use to the property so converted, then, at the election of the taxpayer, the gain shall be recognized only to the extent that the amount realized upon such conversion exceeds the cost of such property.

Ruling Request 1

One of the circumstances in which a § 1033 requisition or condemnation occurs is where a taxpayer's property is subjected to a compensable governmental taking for public use under the Fifth Amendment of the U.S. Constitution. *American Natural Gas Co. v. United States*, 279 F.2d 220 (Ct. Cl. 1960); *Behr-Manning Corp. v. United States*, 196 F. Supp. 129 (D.C. Mass. 1961); Rev. Rul. 69-254, 1969-2 C.B. 162; Rev. Rul. 58-11, 1958-1 C.B. 273. The Fifth Amendment provides, in part, that no "private property be taken for public use without just compensation."

Property within the meaning of §1033

In the present situation, Corp does not hold title to the buildings and other improvements that it constructed on Agency land. However, Corp does have a statutory right or BOI in the facilities. The legislation enacted in Year 2 and Year 3 clearly indicates that Congress intended to provide Corp with the same protections provided by the Fifth Amendment. The language of the statute and underlying contract shows that Congress and Agency intended to effectively place Corp in the same position it would be in if it held title to the improvements. Also, the language of the statute closely parallels that of the Fifth Amendment. This unique statutory scheme is also evidence that Congress intended to treat Corp's BOI as a protected property interest, which constitutes property within the meaning of § 1033.

Taking within the meaning of § 1033

The meaning of condemnation or requisition for purposes of § 1033 of the Code is not strictly limited to takings within the meaning of the Fifth Amendment.

In Rev. Rul. 82-147, 1982-1 C.B. 190, a federal law prohibited the use of motor boats with motors of greater than 25 horsepower on designated lakes in wilderness areas. It also provided that, if the horsepower restriction made the operation of the resort uneconomical, the owner of the resort could require the government to purchase its resort at its fair market value (determined without regard to the horsepower restrictions). The horsepower restriction made the operation of the taxpayer's resort uneconomical and the taxpayer sold its fishing lodge to the federal government.

In holding that the government's purchase of the resort constituted a condemnation within the meaning of § 1033, the Service did not refer to a Fifth Amendment taking, but instead emphasized that the horsepower restriction "in addition to the provision authorizing purchase of a resort at its fair market value without regard to the restriction, effectively constitutes a taking of property upon payment of fair compensation."

In this case, the Year 2 and Year 3 legislation provides, in language similar to the Fifth Amendment, that Corp's BOI shall "not be taken for public use except on payment of just compensation." This language clearly suggests that Congress understood that Agency would have the power to take Corp's BOI for public use. Although this taking is not necessarily a taking under the Fifth Amendment, it is deemed to be (or equivalent to) a taking that qualifies as an involuntary conversion under §1033. In regards to Year 2 and Year 3 legislation, concluding that Corp is ineligible for relief under §1033 would be inconsistent with the Congressional intent to provide Y with the same rights they would have had if they held title to the land and improvements in the X.

The situations and holdings presented in the following two revenue rulings are sufficiently analogous to support this conclusion:

In Rev. Rul. 57-261, 1957-1 C.B. 262, a property owner entered into a contract with a city under the threat of condemnation, and the contract gave the city the option to purchase the property. The contract provided that the city would lease the property for three years and that the city had the option to purchase the land and improvements at stipulated prices. The city subsequently exercised its option under the contract and purchased the land and improvements at the prices stated in the contract. The Internal Revenue Service concluded that the "... the execution of a lease and the exercise of an option contained therein to purchase the property and the improvements thereon is a sale under the threat or imminence of condemnation." The Service also concluded that any gain from the sale of the property was eligible for the relief provisions of § 1033(a).

In the case at hand, Corp executed a contract (that incorporates the underlying statute) with Agency that recognizes Corp's right to just compensation upon the taking of its BOI. The execution of the contract recognizing the BOI and establishing a method for valuing it does not transform the taking into a contractual option to purchase.

Also, Rev. Rul. 81-181, 1981-2 C.B. 162, is consistent with this result. In that ruling, the taxpayer read in a newspaper that a city intended to acquire certain land that was owned by A through condemnation. The taxpayer purchased the property from A knowing that it would eventually be condemned. When the city subsequently approached the taxpayer regarding acquisition of the property, the taxpayer sold it to the city at a gain. The revenue ruling concluded that the fact that the taxpayer knew when he purchased the property that it would eventually be condemned did not disqualify the taxpayer from relief under § 1033.

In the present case, although Corp knew upon executing the contract with Agency that its BOI could be taken on the payment of just compensation, Corp is eligible for relief under § 1033. Corp merely entered into a contract with Agency that recognizes its rights as equivalent to property rights under the Fifth Amendment.

Ruling Request 2

Conversion into Property Similar or Related in Service or Use

With respect to owner-users of converted property, replacement property will be considered to be similar or related in service or use to the converted property if the “physical characteristics and end uses of the converted and replacement properties are closely similar.” Rev. Rul. 64-237, 1964 C.B. 319. In *Maloof v. Commissioner*, 65 T.C. 263, 269 (1975), the Tax Court explains the similar or related in service or use requirement as follows:

[T]he reinvestment must be made in substantially similar business property. *Ellis D. Wheeler*, 58 T.C. 459, 463 (1965). Stated differently, the statute requires a “reasonably similar continuation of the petitioner's prior commitment of capital and not a departure from it.” *Harvey J. Johnson v. Commissioner*, 43 T.C. 736, 741 (1965). While it is not necessary to acquire property which duplicates exactly that which was converted (*Loco Realty Co. v. Com'r*, 306 F.2d 207 (8th Cir. 1962), *rev'g* 35 T.C. 1059 (1961)), the fortuitous circumstance of involuntary conversion does not permit a taxpayer to change the character of his investment without tax consequences. (See *Liant Record, Inc. v. Com'r*, 303 F.2d 326 (2d Cir. 1962), *rev'g* 36 T.C. 224 (1961)).

Section 1033 is a Relief Provision

In determining whether a given taxpayer's receipt of replacement property qualifies under § 1033, courts have long recognized that § 1033 is a relief provision that should be liberally construed to effect its purpose. *E.g.*, *Massillon-Cleveland-Akron Sign Co. v. Commissioner*, 15 T.C. 79, 83 (1950) (interpreting former § 112(f), the precursor to § 1033). Section 1033 provides a means by which a taxpayer whose enjoyment of his property is interrupted without his consent may arrange to have that interruption ignored

for tax purposes, by returning as closely as possible to his original position. *Malloof* at 270, citing *Gaynor News Co. v. Commissioner*, 22 T.C. 1172 (1954). What is required is a reasonable degree of continuity in the nature of the assets as well as in the general character of the business. *Id.* Thus, if the replacement property continues the nature and character of the taxpayer's investment in, or use of, the converted property, it qualifies as replacement property for purposes of § 1033 and gain is deferred.

The old BOI at Z and the new BOI at V and W relate to buildings that were or are used by Corp in its business of operating as Y for X. The vast majority of these buildings are accommodations, retail shops, administrative buildings, and other support buildings, all of which are an essential part of the business of operating as Y for X. Over g percent of the BOI that was taken on Date 1 and Date 2 was in buildings providing accommodations. According to current estimates and projections, over h of the new BOI will be in buildings providing such accommodations.

As stated in *Malloof*, it is not necessary to duplicate exactly what was converted. The key is whether there is a reasonable degree of continuity in the nature of the assets as well as in the general character of the business.

In this case, there is a reasonable degree of continuity in the nature of the assets and the general character of the business. All of the assets are buildings used in the business of operating facilities for X, approximately g percent of which consists of accommodations for X. The general character of Corp's business at V and W is the same as at Z.

CONCLUSIONS

1. There was a condemnation or a requisition of property within the meaning of § 1033 of the Code on Date 1, when Agency acquired a portion of Corp's BOI in the facilities Corp constructed or purchase at Z and, on Date 2, when UNR, at the direction of Agency, acquired another portion of Corp's BOI.

2. The BOI related to facilities in other X operated by Corp (whether acquired by purchase as in the case of W or by construction of additional facilities as in the case of V) constitutes (or will constitute) "other property similar or related in service or use to the property so converted" within the meaning of § 1033(a)(2)(A) of the Code.³

CAVEATS

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter.

³ Following the submission of its original ruling request, Agency awarded Corp a new Y contract for a stated number of years for a portion of Z that may require Corp to invest in additional BOI in Z.

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent. In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representatives.

A copy of this letter must be attached to any income tax return to which it is relevant. Alternatively, taxpayers filing their returns electronically may satisfy this requirement by attaching a statement to their return that provides the date and control number of the letter ruling.

The rulings contained in this letter are based upon information and representations submitted by the Taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

Sincerely,

J. Peter Baumgarten
Assistant to the Branch Chief, Branch 4
Office of Chief Counsel
(Income Tax & Accounting)